COMMENT BY
SAMUEL G. HANSON  Many academics, policymakers, and market participants have recently been pushing for a significant overhaul of money market fund (MMF) regulations. Others oppose any significant changes in these regulations. Why has this historically sleepy corner of the mutual fund sector become a frontline battle in the postcrisis debate about financial regulation? And what can this debate tell us about the theory and practice of financial regulation and its future prospects for success?

In this superb and timely paper, Patrick McCabe, Marco Cipriani, Michael Holscher, and Antoine Martin put forth a novel proposal for MMF reform, which they call the minimum balance at risk (MBR). I begin this discussion by providing some further background on MMFs and explain why a growing number of observers believe that MMFs pose a significant threat to financial stability. I contrast various approaches to financial regulation and argue that the current debate over MMF regulation is best understood through the lens of systemic financial regulation: the goal of these proposals is to better safeguard the stability of the financial system. Drawing heavily on my own recent paper with David Scharfstein and Adi Sunderam, I then lay out what I see as the main goals of MMF reform. Finally, I evaluate three prominent reform proposals—floating net asset values (NAVs), the MBR proposal, and subordinated capital buffers—in light of these goals. I note that the MBR is a form of subordinated capital, so the second and third proposals are close cousins. I argue that these two proposals are far more likely to achieve the goals of MMF reform than floating the NAV.

BACKGROUND ON MMFS  A money market fund is a type of mutual fund that is required by law to invest in short-term, low-risk securities. MMFs pay dividends that reflect the level of short-term interest rates. MMFs come in institutional and retail varieties. Institutional MMFs are high-minimum-investment, low-expense funds marketed to large firms and institutional investors. Retail MMFs are low-minimum-investment, higher-expense funds marketed to households.

Like other mutual funds, MMFs are not insured by the Federal Deposit Insurance Corporation (FDIC) and are regulated by the Securities and Exchange Commission under the Investment Company Act of 1940. However, because MMFs have very low risk compared with other mutual funds, they are exempt under rule 2a-7 of the act from certain regulations that apply to mutual funds more broadly. Specifically, an MMF is not required to mark its assets to market as long as its NAV per share is greater than $0.995. Instead MMFs, like banks, are allowed to use
amortized-cost accounting. However, MMFs are subject to a variety of bank-like regulations that explicitly restrict their asset risk, again setting them apart from other mutual funds.

In November 2012 the Financial Stability Oversight Council (FSOC) solicited public comment on a range of structural reform proposals for MMFs. The principal concern cited by the FSOC is that a wide-scale run on MMFs could result in a systemwide run on large financial firms. Such a run would, in turn, disrupt credit markets and the payments system, with severe adverse consequences for the real economy. This is the “systemic risk posed by MMFs” that motivates the proposal of McCabe and coauthors.

The FSOC asked for comments on three reform proposals for MMFs: the first would require MMFs to “float” their NAVs; the second would require MMFs to maintain a 1 percent subordinated capital buffer and adopt a 3 percent MBR; the third would require MMFs to maintain a 3 percent subordinated capital buffer but no MBR. The second alternative is a variant of the proposal described by McCabe and coauthors and draws heavily on their work.

WHAT DO MMFS DO? Like McCabe and coauthors in this paper, I focus here on prime MMFs, which are thought to pose the greatest systemic risk. Prime MMFs invest in short-term debt instruments issued by private borrowers, mainly large, global banks; only 3 percent of prime MMF assets are in paper issued by nonfinancial firms. Thus, the core function of prime MMFs is to collect savings from households and firms to provide short-term financing to financial institutions (Hanson, Scharfstein, and Sunderam 2013). In other words, prime MMFs function like “correspondent banks” that take deposits and invest those funds in the deposits of other banks.

Prime MMFs create a number of bank-like benefits. On the liability side, they provide savers with money-like, demandable claims—that is, claims with a highly stable nominal value that are redeemable on demand—and offer a variety of transactional services. In addition, MMF shares pay an interest rate that closely tracks movements in short-term market rates such as the federal funds rate, making them attractive relative to the savings products offered by commercial banks (such as savings and money market deposit accounts), which typically pay below-market rates. On the asset side, prime MMFs function as delegated monitors and asset managers, providing savers with access to a diversified portfolio of the short-term liabilities of many large banks. Access to a more diversified portfolio is useful to savers, and delegation may reduce duplicative monitoring in the spirit of Douglas Diamond (1984).

However, MMFs also pose a set of bank-like risks to the stability of the financial system. Since MMF shares are subject to redemption on demand each day, the existence of MMFs arguably
raises the risk of a systemwide run due to the greater systemwide maturity transformation they provide. For instance, imagine a world in which large banks financed themselves by issuing 10-day certificates of deposit (CDs). In such a world, the banking system would need to roll over 10 percent of its funding every night. Now imagine that an MMF sector is inserted between savers and banks. Specifically, suppose that savers invest all of their funds in MMFs, which then buy the banks’ 10-day CDs. Because the MMF shares are redeemable on a daily basis, the financial system would now need to roll over 100 percent of its funding each night, so it is reasonable to conclude that the risk of a systemwide run has increased.

Delegated monitoring also opens the door to agency problems and raises the classic question of “who monitors the monitor?” Indeed, a number of recent studies suggest that MMFs have strong private incentives to take on excessive portfolio risk ex ante (Kacperzyck and Schnabl forthcoming, Chernenko and Sunderam 2013). An increase in an individual fund’s risk will increase that fund’s yield. This increase in yield is likely to result in significant additional inflows from institutional investors, who seek out riskier MMFs with higher yields because they believe they can redeem their shares before bearing any losses. But when investors protect themselves in this way, they exacerbate stresses on MMFs ex post, potentially triggering more widespread financial instability. This yield-seeking behavior also means that MMFs take risk at the worst times from a systemic perspective: the imposition of market discipline occurs in a disorderly fashion late in a crisis, rather than in an orderly fashion in the early stages of a crisis.

FINANCIAL REGULATORY APPROACHES Before I discuss the specific goals of MMF reform, it is worth contrasting several different regulatory approaches: traditional securities regulation, traditional bank regulation, and systemic financial regulation. This contrast is relevant since proponents of overhauling MMF regulations typically adopt the systemic perspective, whereas opponents of significant MMF reform typically advocate more traditional regulatory approaches.

The primary goals of traditional securities regulation—for example, as embodied in the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940—are to ensure that all investors are properly informed about investment products and can transact at fair market prices. More specifically, the goal of traditional securities regulation is to increase transparency, reduce asymmetric information, and protect unsophisticated retail investors.

The goal of traditional bank regulation is to ensure that each individual bank is sufficiently “safe and sound”—for example, that it has enough equity capital—to ensure that FDIC losses and taxpayer bailouts are highly unlikely. For this reason traditional bank regulation is sometimes
described as “microprudential” in nature. The market imperfection motivating microprudential bank regulation stems from moral hazard. Given the existence of mispriced deposit insurance, banks have incentives to take excessive risks to maximize the expected value of taxpayer support. Thus, traditional bank regulation is seen as a necessary counterweight to this moral hazard. Since this view is tied to the existence of deposit insurance, traditional bank regulation is institutional rather than systemic in nature—for example, from this perspective there is no need to regulate a bank that has no recourse to the taxpayer safety net.

Following Hanson, Anil Kashyap, and Jeremy Stein (2011), I take the goal of systemic financial regulation to be that of mitigating the excessive contractions in credit or disruptions of payments that may arise when the financial system is hit with an aggregate shock. Since the goal is to ensure that the financial system as a whole is safe and sound, this is often described as “macroprudential” regulation. In contrast to traditional securities and bank regulation, systemic regulation is decidedly general equilibrium in conception. The idea is that because the financial system is subject to fire-sale and credit-crunch externalities, the amount of leverage and maturity mismatch that is privately optimal for individual financial firms may not be socially optimal, since it makes the system as a whole overly vulnerable to costly financial crises. Since these externalities can arise even in the absence of FDIC-induced moral hazard, systemic regulation is functional as opposed to institutional. Indeed, the systemic regulator worries about credit disruptions from regulated depository institutions, nonbank financial institutions, and markets alike.

GOALS OF MMF REFORM For proponents of systemic financial regulation, prime MMFs appear to be a prime example of regulatory arbitrage. MMFs perform the core economic activities that define banking—they finance illiquid assets with demandable liabilities and undertake liquidity transformation—and pose risks to financial stability similar to those posed by banks. However, unlike banks, MMFs are not subject to subordinated capital requirements and only recently have become subject to bank-like liquidity requirements, two regulatory tools often advocated by proponents of systemic regulation.

Thus, in Hanson and others (2013), we look at MMF regulation through the lens of the systemic approach to financial regulation. We argue that the primary objectives for MMF reform should be threefold. First, regulation should reduce MMFs’ incentives to chase yield and take excessive risk ex ante. Second, regulation should reduce the likelihood of a widespread and systemically disruptive run on MMFs. And third, regulation should attempt to preserve the monetary services that MMFs provide to savers. Otherwise one worries that savings will flow
toward unregulated, MMF-like products that would continue to pose the same risks to financial stability.

EVALUATION OF REFORM PROPOSALS I now discuss the three main alternatives for structural MMF reform that have been put forward by the FSOC: floating the NAV, subordinated capital buffers, and the MBR provision.

Floating the NAV The first proposal is to require MMFs to float their NAV, that is, to report their true NAV and allow investors to transact at it every day, just as all other mutual funds do. This proposal has natural appeal for adherents of traditional securities regulation, since it increases the transparency of MMFs. It may also address the worry that a fixed $1.00 NAV per share places retail investors at a disadvantage because institutions are able to pull their money out more quickly when trouble arises.

However, proponents of floating the NAV also cite two potential systemic benefits. First, moving to a floating NAV may lower the probability of “strategic” runs on MMFs. Currently, if the true NAV falls, investors who redeem early receive $1.00 per share, while those who redeem late receive less. This cliff effect creates a strategic motive to run. Second, moving to a floating NAV might lower the probability of “panicked” runs, because it would remove the regulatory imprimatur of safety that MMFs enjoy and force skittish, risk-averse investors to recognize that MMFs are not completely safe.

In Hanson and others (2013) we argue that these systemic benefits are likely overstated. First, since most prime MMF assets tend to be quite illiquid—secondary markets for short-term private paper are extremely thin—the strategic incentive for MMF investors to run at the first sign of danger is likely to remain. Specifically, the incentive to run stems from the combination of demandable liabilities and illiquid assets, as in Diamond and Philip Dybvig (1983), not simply from the cliff effect due to a fixed $1.00 NAV. Investors who redeem early get paid in full but consume the fund’s more liquid assets. By contrast, investors who redeem late will receive the depressed, fire-sale value of the fund’s more illiquid paper. Indeed, the recent crisis also saw widespread runs on MMF-like products with variable NAVs, including ultra-short bond funds in the United States and variable-NAV MMFs in Europe.

Second, floating-NAV MMFs would continue to attract a highly skittish, risk-averse investor base. They would still be subject to strong risk-limiting provisions under rule 2(a)7 and thus would continue to benefit from a strong regulatory imprimatur of safety. Furthermore, since the
NAV would fluctuate little, if at all, in normal times, highly risk averse investors would still be drawn to the product, setting the stage for runs at the first sign of danger.

*Subordinated capital buffers* The idea of a junior capital buffer is quite simple. A capital buffer divides the risks and rewards of MMF assets between subordinated capital, which bears the first losses, and ordinary, senior MMF shares. In return for the protection provided by a subordinated capital buffer, the latter would earn a slightly lower yield in normal times.

In Hanson and others (2013) we argue that subordinated capital buffers are the preferred regulatory solution from the standpoint of reducing systemic risk, for several reasons. First, junior capital reduces the probability of systemwide runs. Senior MMF shares will be protected by the capital buffer, so MMFs would have to suffer larger losses than under current rules before ordinary MMF investors are endangered. Second, because subordinated capital providers bear the first losses, they will have an explicit incentive to discipline ex ante risk taking. Indeed, Marcin Kacperzyck and Philipp Schnabl (forthcoming) show that fund sponsors, who implicitly have capital at stake, rein in the risk taking of their MMFs. Finally, subordinated capital preserves—and potentially enhances—the monetary benefits enjoyed by ordinary MMF shareholders and would be unlikely to trigger a migration to less regulated savings products.

Hanson and others (2013) perform a calibration based on Oldrich Vasicek’s (2002) model of credit portfolio losses. For a well-diversified portfolio of MMF assets, our estimates suggest that a 4 percent subordinated capital buffer would reduce the probability that senior shares suffer losses to 0.1 percent, the tolerance level used in the Basel II bank capital regulations. In return for this protection, we estimate that senior shares would earn just 0.05 percent less in normal times.

*Minimum balance at risk* Under the minimum balance at risk proposal of McCabe and coauthors, some fraction (say, 3 or 5 percent) of each investor’s recent balances would be available for redemption only with a delay of 30 days. This would ensure that sophisticated investors cannot chase yield and then run at the first sign of danger, sticking less sophisticated investors with all the losses. Furthermore, the “strong MBR” proposal advocated by these authors adds a conditional subordination feature whereby the MBRs of redeeming investors become subordinated relative to those of nonredeemers and bear the first losses if the MMF breaks the buck. As the authors argue, this strong MBR provision provides an explicit disincentive for MMF investors to withdraw when concerns about moderate fund losses arise.

Thus, the proposed MBR is a form of subordinated capital. The main differences between an actual capital buffer and the MBR have to do with who provides the capital and when they provide
it. With an MBR, risk-averse MMF investors are forced to provide junior capital ex post. With a capital buffer, other, more risk tolerant investors or the fund sponsor provide this junior capital ex ante.

There are costs and benefits of each approach. The MBR may be more effective at discouraging excessive risk taking, because the MMF investors themselves are forced to bear the costs of chasing yield ex ante. With respect to reducing the tendency for investors to run ex post, note that the MBR assigns losses to skittish, risk-averse investors in a complex fashion, whereas a capital buffer assigns losses to more risk tolerant investors in a simple fashion. If one adopts a rational, strategic view of runs, the MBR may be more effective at discouraging them. However, if one adopts a more behavioral, panic-based view of runs, one might worry that the MBR would be less effective. Finally, the MBR may partially diminish the value of the monetary services provided by MMFs. As a result, one may worry that a large MBR requirement might lead savers to substitute away from MMFs and toward other unregulated products, which may also pose threats to financial stability.

Overall, a subordinated capital buffer and an MBR are quite similar, and either could largely achieve the goals of MMF reform. Furthermore, as the authors note, these approaches may be complementary, so that a hybrid of buffer and MBR solutions may be most effective.

CONCLUSION In the aftermath of the crisis, the broad question is where to draw the line between investment products that can be left largely unregulated, such as hedge funds, and core financial and payments services that require stronger regulation. The debate on MMF reform reflects this broader question. Floating-NAV proposals hope to move MMFs firmly into the investment category, a realm where policymakers are typically happy to stop at the objectives of traditional securities regulation. Proposals for capital buffers and MBRs would bring MMFs further under the regulatory umbrella in the name of systemic risk regulation. I have argued that the combination of demandable liabilities and illiquid assets that defines MMFs means that a systemic or macroprudential approach is essential and, thus, that the latter approach is likely to be most effective.

References


The FSOC was created by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which grants the FSOC broad authority to monitor and respond to emerging threats to financial stability.

MMFs are classified as prime, government, or tax-exempt. According to the Investment Company Institute, MMFs managed a total of $2.60 trillion in assets as of November 2012. Most of these assets ($1.45 trillion) were in prime MMFs. The remainder were in government MMFs ($0.87 trillion), which hold Treasury bills and other short-term U.S. government and agency paper, and in tax-exempt MMFs ($0.27 trillion), which hold short-term paper issued by states and municipalities.